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# ECONOMIC OUTLOOK

**T**he national and California economies strengthened in the second half of 2003. Increased business investment and job growth—the two missing pieces of a sustainable, stronger economic recovery—appeared to be in place as the year ended. Improved labor markets and stronger output growth are expected for both economies in 2004 and 2005.

National economic output expanded at its fastest rate in nearly 20 years in the third quarter. Even better, the gain was broad-based across spending categories. Tax refunds and tax rate cuts spurred consumers to boost their spending. Businesses invested considerably more in equipment and software. Residential construction posted a big gain. Even net exports added to the economy's growth. While the first estimate of fourth quarter economic output will not be released until late January, monthly statistics in October and November depicted an economy continuing to forge ahead. Particularly encouraging, nonfarm payroll employment grew for the fourth consecutive month in November.

California personal income increased for the sixth consecutive quarter in the second quarter of 2003. Also encouraging, exports of made-in-California merchandise began

to increase again in the third quarter after falling for nearly three years, and taxable sales posted a fifth consecutive year-over-year gain. In addition, manufacturing activity expanded in the third quarter in the Inland Empire and Orange County, according to local surveys of purchasing managers. But California labor markets were not as strong as those in the rest of the nation, on average, near year-end. Southern California labor strikes played a role in that below-average performance.

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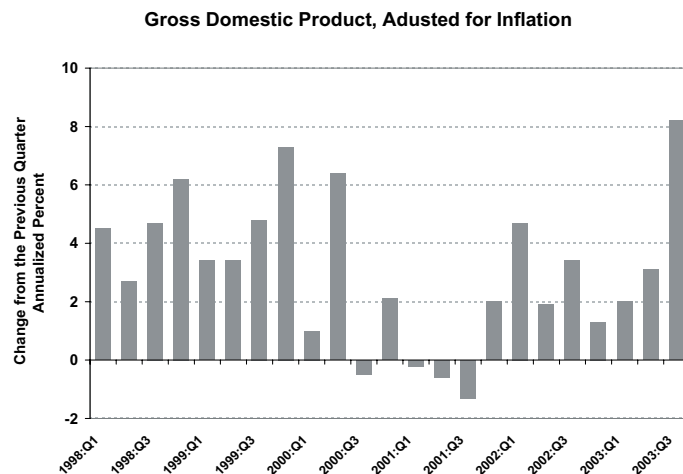
## The Nation — Strengthening Recovery

Adjusted for inflation, the national economy grew by an annualized 8.2 percent in the third quarter—the fastest pace since the first quarter of 1984 (Figure ECON-1). While personal consumption expenditures made the biggest contribution to that growth, the other three major spending categories—gross private domestic investment, net exports of goods and services, and government spending—also contributed.

Spurred by recent tax cuts, including an advance payment of \$400 per child on an expanded federal tax credit for children under 16 and reduced withholding, households



FIGURE ECON-1



spent significantly in the third quarter. Real personal consumption expenditures grew by 6.4 percent. Sales of light vehicles were especially strong as better factory incentives on new cars and light trucks sped vehicles off dealer lots in July and August. Spending on other durables, nondurables, and services was also robust. A reduction in factory incentives in September pulled down light vehicles sales, however.

Businesses did their part by boosting investment considerably in the third quarter. Gross private domestic investment grew by over 18 percent at a seasonally adjusted, annual

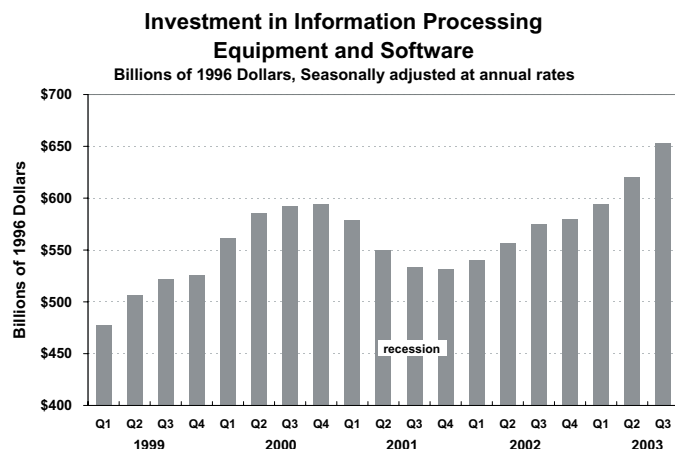
rate. Within this category, nonresidential fixed investment expanded by 14 percent—its first double-digit gain since 2000—and residential investment, by 23 percent. Inventory investment, by falling less in the third quarter than in the second, also contributed significantly to growth in gross private domestic investment.

The large hike in business investment contained good news for the nation's high-tech sector. Spending on information processing equipment and software surged by 23 percent (Figure ECON-2). Investment in computer and peripheral equipment, a component of information processing equipment, soared by 47 percent on top of a 53 percent gain in the second quarter—the best two consecutive quarters since 1999. All of this was particularly encouraging because the primary cause of the economy's sluggishness earlier in the recovery was weak business investment.

Net exports and government spending did not contribute much to output growth, but gains in net exports are so rare today that they deserve to be noted. Net exports boosted economic growth by subtracting less from Gross Domestic Product in the third quarter than in the second quarter. Exports rose by 11 percent while imports inched up by 1.5 percent. Government spending, on the other hand, can make a significant contribution to economic growth, as it did in the second quarter when defense spending skyrocketed. But defense spending fell slightly in the third quarter, making the government sector's contribution quite small.

Aside from the good news on spending, the third-quarter real GDP report had positive implications for business profits. With soaring output growth and only modest increases in hours worked, economic profits exceeded \$1 trillion on an annualized basis. The high

FIGURE ECON-2



point for economic profits during the 1990s expansion was \$860 billion in the third quarter of 1997.

Monthly statistics on the economy's performance in October and November also were heartening. Some of the best news came from the labor markets, where unemployment went below 6 percent again in November, and nonfarm payroll employment grew for the fourth consecutive month. The string of job gains nearly guarantees that nonfarm employment posted a gain in the fourth quarter. If so, it was only the third gain in three years. However, manufacturing jobs dropped for the 40<sup>th</sup> consecutive month in November.

In addition, the University of Michigan consumer sentiment index rose to 93.7 in November, higher than it averaged in 2001, 2002, and the first ten months of this year. And, the Institute for Supply Management's (ISM) non-manufacturing index remained above 60 in November, suggesting that the services sector continued to grow very strongly well into the fourth quarter. (A reading above 50 indicates expansion.) Not to be outdone, the ISM's manufacturing index jumped to 62.8 in November, its highest level in nearly 20 years. Moreover, the manufacturing employment sub-index topped 50 for the first time in three years. Low inventory levels and strong sales have finally prompted a surge in manufacturing activity. Elsewhere, residential housing starts reached their highest level since 1986 in October, but light vehicle sales slumped again in October before rebounding in November.

Despite these encouraging signs, it is unlikely that economic output grew as quickly in the fourth quarter as it did in the third. Households received tax cuts worth \$120 billion at an annual rate in the third quarter and ap-

parently spent much of it. The tax cuts will remain in force through at least the end of 2004, but there are no additional planned cuts to provide a further boost in growth. Also, with higher interest rates slowing home refinancing, cash-out refinancing did not provide the kick to spending that it did in the third quarter. Moreover, generous incentives on new vehicles padded third quarter consumer spending at the expense of fourth quarter growth. And, new labor contracts with the United Auto Workers union make it easier to close plants, eliminating the need to offer generous buyer incentives. Instead of adding about \$30 billion to real GDP, as seen in the third quarter, the throttling back on incentives probably reduced spending on light vehicles by over \$40 billion in the fourth quarter. Excluding light vehicles purchases, consumer spending likely grew by about 3.6 percent at an annual rate in the fourth quarter as compared to 4.8 percent in the third quarter.

Despite the slowdown in consumer spending, economic output likely grew by about 3.6 percent in the fourth quarter, as firms continued to boost their investment in new equipment and software. Also, inventories grew in September and were expected to grow throughout the fourth quarter. Businesses drew down inventories in the second and third quarters and likely had to rebuild them with the economy growing more strongly.

International trade was the most uncertain sector for the fourth quarter. Net exports added to economic growth in the third quarter, but the last time they added to economic growth in consecutive quarters was in 1995. The U.S. dollar has declined by nearly 12 percent in trade-weighted value since early 2002, making domestically produced goods more competitive. Over the long run, a weaker dollar should lead to stronger net exports. Recent data on foreign capital flows



into the U.S. treasury and stock markets indicate a marked slowdown of foreign interest in U.S. financial assets. Most likely, net exports deteriorated slightly in the fourth quarter.

Growth should accelerate to 4.2 percent in 2004. After cooling in the fourth quarter, consumer spending will pick up in 2004, fueled by bigger employment gains and larger than normal tax refunds. The tax package in May 2003 lowered rates for the entire year but only adjusted tax withholding on wages starting in July. As a result, workers likely had too much withheld from their paychecks in 2003. The overpayment will increase tax refunds in the first two quarters of 2004. Large tax refunds and moderate employment gains, especially in the second half of the year, will result in a 3.5 percent to 4 percent gain in real consumer spending for 2004.

The stronger economic climate and the temporary tax incentives for investment in equipment and some software introduced in the May 2003 tax package will boost investment spending further in 2004. With the tax incentives scheduled to expire at the end of 2004, businesses will speed up purchases of equipment and software to take advantage of the incentives. Investment in producer's durable equipment is expected to grow by over 11 percent in 2004 compared to just over 5 percent in 2003.

Investment in nonresidential structures will pick up, but high vacancy rates for commercial and industrial structures will keep growth slow. Higher mortgage rates should finally slow down residential construction. Still, home building has been surprisingly resilient for many years.

Nonfarm payroll employment will grow by about 150,000 jobs per month in the first two quarters of 2004 before accelerating to about 250,000 per month for the remainder of the year. This is somewhat slow by histori-

cal standards, but rapid productivity growth and a more competitive international environment, especially in manufacturing, will restrain hiring.

Economic profits will be strong again in 2004, increasing by about 15 percent. Rising profits and relatively low interest rates will provide a good environment for additional stock market gains.

Tight energy supplies pose a risk to the outlook. Worldwide oil production is currently close to capacity, and the gap between supply and demand in the North American natural gas market is very thin. A disturbance to oil output or unusually cold weather in North America this winter could cause energy prices to soar just as world growth is set to accelerate in 2004. Although it would take a very large spike to completely derail the U.S. recovery, a persistent rise in energy prices would dampen growth.

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## **California— Improving Vital Signs**

The California economy also is looking better. State personal income is increasing. Housing markets continue to be healthy with surprisingly strong price appreciation. New business incorporations are up from a year ago. Taxable sales were higher than a year earlier in the last two quarters of 2002 and the first three quarters of 2003. The state's high-tech firms are making money again, tourism has improved, and made-in-California exports have finally turned up.

State personal income grew in the second quarter of 2003 (the most recent data) for the sixth consecutive quarter, and the cumulative growth of personal income over the six-quarter period was greater in the state than in the nation. The U.S. Commerce

Department will not release its first estimate of California third quarter personal income until late January. That number will shed light on whether the state economy surged as much as the national economy in the third quarter. Until then, it is encouraging to note that third-quarter 2003 California personal income tax withholding was up about 8 percent from the year-ago level.

Statewide taxable sales also are improving. Third-quarter 2003 sales were higher than year-earlier sales, making it the fifth consecutive quarter of year-over-year gains. While the gains were modest, they were a considerable improvement over the declines of the preceding four quarters. And the third quarter gain was the biggest of the five consecutive gains, in line with the spurt in the national economy in the third quarter.

Recent payroll employment reports have brought little good news, however. Non-farm payroll employment was essentially flat during 2002 and the first ten months of 2003. The grocers' strike in Southern California pulled down payroll employment in November and most likely held it down in December. Still, the percentage decline in jobs from the end of the national recession in November 2001 to November 2003 was a bit less in the state, 0.3 percent, than in the nation, 0.6 percent.

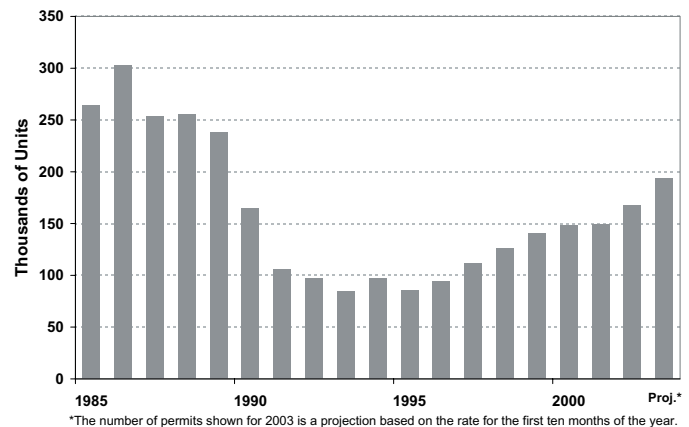
The hemorrhaging of jobs in the San Jose and San Francisco metropolitan areas has slowed considerably. Nonfarm payroll employment in November 2003 was down 3.4 percent from a year earlier in the San Jose metropolitan area and 1.4 percent in the San Francisco metropolitan area. A year ago, employment was down 6.4 percent and 3.4 percent, respectively, in the two metropolitan areas. By the same measure, however, job growth slowed over the last year in all the other major metropoli-

tan areas except for Bakersfield. Job growth has become much less varied across major metropolitan areas in the state.

Construction was up in the first ten months of 2003. Through October, home permits were on a pace to hit 194,000 units for the year, roughly a 16 percent gain over 2002 and the highest level since 1989 (Figure ECON-3). Five counties

FIGURE ECON-3

### California Residential Housing Permits



accounted for nearly half of the units permitted: Riverside, Los Angeles, San Diego, Sacramento, and San Bernardino. Private sector nonresidential building, on the other hand, was down in value, with a decline in new office building construction most responsible. If private-sector nonresidential building was down for the year as a whole, it was the third consecutive yearly decline. Public works construction was up slightly with a sizable gain in public building construction—such as schools and community colleges—more than offsetting a considerable decline in roads, bridges, and other heavy construction.

California housing markets were strong again in 2003. In the first ten months of 2003, sales of existing, detached single-family





homes were up 3.5 percent from a year earlier, according to the California Association of Realtors. The year-over-year percentage increase in the median price of these homes was in the mid-teens most months. The median price breached \$400,000 for the first time in August before dipping below that figure in September and October.

Commercial real estate markets were a bit better. Office vacancy fell in the Oakland and San Jose metropolitan areas and Orange, San Diego, and Ventura Counties in the third quarter of 2003. Office vacancy in the San Jose and San Francisco metropolitan areas continued to be considerably above the national average for U.S. markets surveyed by CB Richard Ellis. Ventura and San Diego Counties and the Sacramento metropolitan area, on the other hand, were among the five metropolitan areas with the lowest office vacancy rates. Sacramento's vacancy rate, however, has increased over two percentage points in the last year. Industrial vacancy was less of a problem despite vacancy being slightly above the national average in San Francisco and considerably above the national average in Sacramento in the third quarter. Vacancy rates in San Diego and Los Angeles were well below the national average.

Exports of California-made merchandise are growing again after falling by about 25 percent from the third quarter of 2000 to the third quarter of 2003. With high-tech products making up such a big share of California exports (more than 50 percent in 2000), the global high-tech recession took a bigger toll on California's exports than on almost all other states'. State exports of computer and electronics products fell by 46 percent. It looks like exports of California-made computer and electronics products may be growing again. Exports of transportation equipment, chemicals, agricultural products, and food

and kindred products grew considerably over the last four quarters. By major markets, state exports to Mexico, South Korea, the United Kingdom, and Taiwan fell substantially between the third quarter of 2002 and the third quarter of 2003, while those to Japan, Canada, Hong Kong, and Australia grew considerably.

California's tourism industry continues to improve while remaining below pre-September 11 levels. The "drive-to" market is doing best, convention business is improving, but business travel remains weak. Hotel and motel occupancy rates improved in all major markets, except San Jose, in the first nine months of 2003, but in most cases at the expense of lower average daily room rates.

The recovery of the California economy broadened and strengthened in the second half of 2003. The turnaround in state exports and taxable sales is an important step toward stronger growth. A year ago, state exports were falling at a brisk pace, and taxable sales were in the middle of four consecutive quarterly year-over-year declines. In addition, job losses slowed considerably in the San Jose metropolitan area and may have ended in the San Francisco and San Jose metropolitan areas as 2003 wound down. Profits are again being made in the Silicon Valley. Residential construction and real estate remain strong.

The outlook for the California economy in 2004 depends heavily on the fate of the national economy. The national economy grew at breakneck pace in the third quarter of 2003. Most likely the California economy did as well, but enough quarterly economic statistics on the state economy to confirm that assertion will not be available until at least the end of January 2004. By one important measure, job growth, the state economy under-performed the national economy in the second half of 2003. While strikes

in Southern California were at least partly responsible, it will be important to see some job growth in the early months of 2004. Job growth is necessary for a sustainable stronger recovery.

Low interest rates and a considerable amount of federal fiscal stimulus will boost the state and national economies in 2004. Cuts in expenditures to reduce state and local government budget deficits will be a drag on the state and national economies, however. On balance, the outlook for the

California economy is for moderate growth in 2004 and even better growth in 2005 (Figure ECON-4). Unemployment will likely remain above 6 percent throughout the period. Personal income will grow by about 5.6 percent in 2004 and almost 6 percent in 2005—good, but not as quickly as in past recoveries. Consumers are the linchpins of this outlook. They have to continue to be optimistic that stronger labor markets lie just ahead.

FIGURE ECON-4

### Selected Economic Data for 2003, 2004, and 2005

	Forecast		
United States	2003	2004	2005
Real gross domestic product (1996 dollar, percent change)	2.9	4.2	3.6
Personal consumption expenditures	3.1	3.5	3.4
Gross private domestic investment	3.5	9.1	4.7
Government purchases of goods and services	3.3	2.4	1.3
GDP deflator (1996=100, percent change)	1.6	1.6	1.8
GDP (current dollar, percent change)	4.6	5.9	5.5
Federal funds rate (percent)	1.12	1.44	2.63
Personal income (percent change)	3.2	5.1	5.8
Corporate profits before taxes (percent change)	15.6	11.2	37.3
Nonfarm wage and salary employment (millions)	130.1	131.7	134.5
(percent change)	-0.2	1.3	2.1
Unemployment rate (percent)	6.0	6.0	5.8
Housing starts (millions)	1.79	1.72	1.63
(percent change)	4.7	-4.2	-5.3
New car sales (millions)	7.6	7.7	7.7
(percent change)	-5.5	0.4	0.7
Consumer price index (1982-84=100)	184.1	187.7	192.0
(percent change)	2.3	2.0	2.3
California			
Civilian labor force (thousands)	17,618	17,818	18,139
(percent change)	1.2	1.1	1.8
Civilian employment (thousands)	16,440	16,629	16,954
(percent change)	1.2	1.2	2.0
Unemployment (thousands)	1,179	1,189	1,185
(percent change)	1.6	0.8	-0.3
Unemployment rate (percent)	6.7	6.7	6.5
Nonfarm wage and salary employment (thousands)	14,443	14,602	14,906
(percent change)	-0.2	1.1	2.1
Personal income (billions)	\$1,199.0	\$1,266.4	\$1,340.6
(percent change)	3.8	5.6	5.9
Housing units authorized (thousands)	194	192	198
(percent change)	15.8	-1.5	3.2
Corporate profits before taxes (billions)	\$98.2	\$110.0	\$118.5
(percent change)	4.9	12.0	7.8
New auto registrations (thousands)	1,710	1,703	1,746
(percent change)	-0.7	-0.4	2.5
Total taxable sales (billions)	\$451.1	\$477.2	\$503.0
(percent change)	2.3	5.8	5.6
Consumer price index (1982-84=100)	190.6	194.2	199.4
(percent change)	2.4	1.9	2.7

Note: Percentage changes calculated from unrounded data.